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Nos. 492-493.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1938.

GENERAL GAS AND ELECTRIC CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

BRIEF ON BEHALF OF PETITIONER SUR WRITS OF CERTIORARI GRANTED JANUARY 3, 1939.

MAURICE BOWER SAUL,
Counsel for Petitioner.

WILLIAM H. S. WELLS,
BRADFORD S. MAGILL,
C. M. TRAMMELL,
Of Counsel.

ERRATA:

The references herein to the Record are to the pages of the original Transcript of the Record in case No. 492 (with the exception noted below) and differ from the pages in the re-printed Transcript of the Record as follows:

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1938. NOS. 492-493.

General Gas and Electric Corporation,
Petitioner,

v.

Commissioner of Internal Revenue,
Respondent.

BRIEF ON BEHALF OF PETITIONER SUR WRITS OF CERTIORARI GRANTED JANUARY 3, 1939.

OPINIONS OF THE COURTS BELOW.

The opinion of the Circuit Court of Appeals is reported in 98 Fed. (2d) 561. It will be found on page 184 of the Record.* The findings of fact and the opinion of the Board of Tax Appeals are contained in a memorandum opinion entered June 3, 1937, and will be found on pages 166-176 of the Record.

*There are two petitions to the United States Board of Tax Appeals, one bearing Docket No. 52639 and the other bearing Docket No. 59469. The cases were consolidated before the Circuit Court and since all of the facts essential to the determination of the proceedings appear in case bearing Docket No. 52639, all references to the Record refer to the Record in that case.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on July 18, 1938 (R. 184). The petition for re-hearing was filed on August 3, 1938, within the time provided by the rules of the Circuit Court of Appeals for the Second Circuit (R. 188), and the petition for re-hearing was denied September 1, 1938 (R. 192). On December 1, 1938, petitioner filed with your Honorable Court a petition for writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit, which petition was allowed by your Honorable Court on January 3, 1939.

STATUTES INVOLVED.

Section 237 (a) of the Revenue Act of 1926. (Appendix C, *infra*) Section 23 of the Act of April 29, 1874, as amended, of the Pennsylvania General Assembly, Title, 15 Purdon's Statutes, Section 595 (Appendix B, *Infra*).

STATEMENT OF THE CASE.

Petitioner, General Gas and Electric Corporation, a corporation organized and existing under the laws of the State of Delaware, is and was at all times material to this proceeding, engaged in the business of holding securities thereby controlling public utility subsidiaries serving in various States (R. 96).

By an agreement entered into by and between the General Gas and Electric Corporation and its subsidiaries, the entire Federal Income Tax liability of

each subsidiary corporation is to be assessed against and paid by the General Gas and Electric Corporation (R. 96).

In March, 1926, the Northern Pennsylvania Power Company (a Pennsylvania Corporation), an affiliated subsidiary of the General Gas and Electric Corporation, acquired all of the assets, property and franchises and assumed all of the liabilities of the North Penn Power Company (a Pennsylvania Corporation) pursuant to and by virtue of the provisions of Section 23 of the General Corporation Act of 1874, as amended (appendix *infra*), of the laws of the Commonwealth of Pennsylvania (R. 96, 97).

Included among the liabilities of the North Penn Power Company, which has been assumed by the Northern Pennsylvania Power Company, were bonds in the principal sum of $552,700 (R. 97).

During the years 1926 and 1927 the Northern Pennsylvania Power Company retired all of the aforesaid outstanding bonds of the North Penn Power Company. At the time of retirement in 1926 there remained as unamortized debt discount and expense incurred upon the issuance and sale of these bonds the sum of $47,058.08 and with respect to those retired in 1927 the unamortized debt discount and expense amounted to $53,441.71 (R. 98).

In 1926 the Northern Pennsylvania Power Company also acquired, pursuant to the provisions of Section 23 of the General Corporation Act of 1874, as amended (appendix *infra*), of the laws of the Commonwealth of Pennsylvania, all of the assets and assumed all of the liabilities of the Susquehanna County

Light and Power Company (a Pennsylvania Corporation) (R. 99).

Included among the liabilities of the Susquehanna County Light and Power Company were bonds in the principal amount of $600,000. In 1926 the Northern Pennsylvania Power Company redeemed and retired the entire issue of the aforesaid bonds. At the date of redemption there remained $19,922.11 unamortized debt discount and expense which had been incurred upon the issuance and sale of the bonds by the Susquehanna County Power and Light Company (R. 100).

For the taxable years 1926 and 1927 General Gas and Electric Corporation filed consolidated income tax returns for itself and its subsidiaries, including the Northern Pennsylvania Power Company. In its returns for those years the General Gas and Electric Corporation in computing the taxable income deducted the unamortized debt discount and expense sustained by the Northern Pennsylvania Power Company at the time of the retirement by it of the bonds of the North Penn Power Company and the Susquehanna County Light and Power Company.

The Commissioner of Internal Revenue refused to allow the deductions in the years 1926 and 1927. Petitioner filed separate petitions to the United States Board of Tax Appeals, one for the year 1926 and the other for the year 1927, and since they presented a common question of law the same were consolidated for hearing before the Board which held in a memorandum opinion that the unamortized debt discount

and expense were not proper deductions and determined deficiencies in petitioner's income tax for those years in the amounts of $24.21 and $3,164.80 respectively (R. 171 in case bearing Docket No. 52,639 and R. 177 in case bearing Docket No. 59,469). Separate petitions for review were presented to the Circuit Court of Appeals for the Second Circuit, which petitions were consolidated and the orders of the Board of Tax Appeals affirmed in the judgment rendered by that Court.

On December 1, 1938, petitioner filed with your Honorable Court petitions for writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit, alleging that the decision of the court below was in conflict with the decisions of the Circuit Court of Appeals for the Third Circuit in *Metropolitan Edison Company* v. *Commissioner*, 98 F. (2d) 807 and *Pennsylvania Water & Power Company* v. *Commissioner*, 98 F. (2d) 812, which cases presented precisely the same question as the instant case and involved the same Federal Statutes and regulations and the same provisions of the Pennsylvania Statutes. Your Honorable Court allowed petitions for writs of certiorari on January 3, 1939.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred—

1. In holding that the absorption of the North Penn Power Company and the Susquehanna County

Light and Power Company by the Northern Pennsylvania Power Company pursuant to the provisions of Section 23 of the Pennsylvania General Corporation Act of 1874 as amended, did not have the incidents of a strict merger under Pennsylvania law.

2. In holding that the Northern Pennsylvania Power Company in determining its net taxable income was not entitled to deduct the unamortized debt discount and expense in connection with the bonds of the North Penn Power Company and Susquehanna County Light and Power Company which were redeemed and retired in the taxable years 1926 and 1927.

3. In entering judgment for the respondent.

SUMMARY OF ARGUMENT.

It is conceded as a general proposition, that a corporation which succeeds through merger to the assets and liabilities of a corporation issuing bonds at a discount, is entitled to the same deductions for income tax purposes on account of unamortized bond discount and expense as the issuer when the bonds are retired prior to maturity.

The transactions by which the Northern Pennsylvania Power Company succeeded to the assets and liabilities of the North Penn Power Company and the Susquehanna County Light and Power Company in accordance with the provisions of Section 23 of the Act of 1874 as amended, were, under Pennsylvania law, strict mergers.

Transactions such as those involved in the present case effected under the provisions of Section 23 of the Act of 1874 as amended, are strict mergers since under the Pennsylvania law the absorbed companies ceased to exist and all of their assets and liabilities were, by operation of law, assumed by the Northern Pennsylvania Power Company.

Regardless of the technical nature of the transactions in the present case by which the Northern Pennsylvania Power Company acquired the assets and liabilities of the affiliated companies, the result was a change in form only so that the loss represented by the unamortized bond discount and expense was actually sustained by the Northern Pennsylvania Power Company when it retired the bonds of the absorbed companies prior to maturity and, therefore, it should be allowed to deduct the same in computing its net income for tax purposes.

I.

Preliminary Statement.

Your Honorable Court granted petitions for writs of certiorari in three cases involving substantially the same issues, namely, *Commissioner of Internal Revenue* v. *Metropolitan Edison Company*, No. 486, October Term 1938, *Commissioner of Internal Revenue* v. *Pennsylvania Water and Power Company*, No. 487, October Term 1938, and *General Gas and Electric Corporation* v. *Commissioner of Internal Revenue*,

Nos. 492-493, October Term 1938. All three of these cases are now before the Court for hearing.

Each of the three taxpayer corporations in filing in conjunction with their subsidiary companies consolidated income tax returns for the years 1926, 1927 and 1928, as the case might be, deducted unamortized debt discount and expense remaining upon the retirement in those years of bonds previously issued by corporations which had been absorbed by the taxpayer corporations or their subsidiaries in compliance with the laws of Pennsylvania. In each instance the Commissioner of Internal Revenue disallowed the deductions and in so doing was sustained by the United States Board of Tax A, eals. All three taxpayer corporations filed separate petitions for review of the judgment of the United States Board of Tax Appeals with the United States Circuit Court of Appeals having jurisdiction in the particular case.

The General Gas and Electric Corporation filed its petition for review in the United States Circuit Court of Appeals for the Second Circuit. The Metropolitan Edison Company and the Pennsylvania Water and Power Company filed their petitions for review in the United States Circuit Court of Appeals for the Third Circuit.

In each case counsel for the Commissioner of Internal Revenue conceded that unamortized discount and expense incurred in connection with the issue and sale of bonds are allowable deductions to a successor corporation when it pays off the bonds prior to maturity, provided the successor corporation, through

merger or consolidation, has carried forward the corporate identity of the issuing corporation and has succeeded, by operation of law, to its rights and liabilities. The issue in each case, therefore, was whether the transactions by which the taxpayer corporations or their subsidiaries had absorbed other corporations under Pennsylvania law were such as to entitle the taxpayer corporations or their subsidiaries to deduct the unamortized discount and expense incurred in connection with the issue and sale of bonds by the absorbed corporations when such bonds were paid off by the taxpayer corporations or their subsidiaries prior to maturity.

In deciding this issue the Circuit Court of Appeals for the Second Circuit found that the transactions involved in the *General Gas and Electric Corporation* case constituted a purchase rather than a merger under Pennsylvania law, and that therefore, it was not entitled to deduct the unamortized debt discount and expense in connection with the bonds issued by the absorbed corporations when the same were retired prior to maturity. In deciding substantially the same issue with respect to the transactions involved in the *Metropolitan Edison Company* case and the *Pennsylvania Water and Power Company* case, the Circuit Court of Appeals for the Third Circuit found that under Pennsylvania law they were such as to entitle the taxpayer corporations to deduct the unamortized debt discount and expense in connection with the bonds issued by the absorbed corporations when the bonds were retired prior to maturity.

We have therefore a direct conflict in the two Circuit Courts of Appeals in cases involving similar if not identical situations and issues.

It is contended on behalf of the petitioner, the General Gas and Electric Corporation, that the Circuit Court of Appeals for the Second Circuit erred in holding that the transaction by which its subsidiary, the Northern Pennsylvania Power Company succeeded to the assets and liabilities of two of its subsidiaries, the North Penn Power Company and the Susquehanna County Light and Power Company, were not under Pennsylvania law strict mergers and, that, it further erred in failing to hold that the transactions involved a change in form only so that, irrespective of the technical nature of the transactions, the deductions claimed for income tax purposes should have been allowed.

II.

A Corporation Succeeding Through Merger to the Assets and Liabilities of a Corporation Issuing Bonds at a Discount, in Retiring Such Bonds Prior to Maturity, is Entitled to the Same Deductions on Account of Bond Discount and Expense as the Issuing Corporation.

In corporate finance it is a common practice to issue bonds at a discount where the interest rate specified in a long term bond is less than the market rate so that investors are unwilling to pay par for the bonds. This discount, along with the expense involved upon the issuance of the bonds, is amortized over the life of the bonds and if the bonds are retired

prior to maturity, the unamortized bond discount and expense constitutes a loss. The remainder of the discount which has not been amortized must be paid by the corporation from its surplus or other funds.

As the Circuit Court of Appeals for the Second Circuit in this case, reported in 98 Fed. (2d) 561, stated in its opinion at page 563 of the Reports: "It is conceded that unamortized discount and expenses incurred in connection with the issue and sale of bonds are deductions available to the issuing corporation when it pays them off prior to maturity. See *Helvering* v. *Union Pacific R. Co.*, 293 U. S. 282, 55 S. Ct. 165, 79 L. Ed. 363; *Great Western Power Co.* v. *Commissioner*, 297 U. S. 543, 56 S. Ct. 576, 80 L. Ed. 853. It is also not disputed that such items are allowable deductions to a successor corporation which through merger or consolidation has carried forward the corporate identity of the issuing corporation and has succeeded by operation of law to its rights and liabilities. *American Gas & Elec. Co.* v. *Commissioner*, 2 Cir., 85 F. (2d) 527; *New York Central R. Co.* v. *Commissioner*, 2 Cir., 79 F. (2d) 247, certiorari denied 296 U. S. 653, 56 S. Ct. 370, 80 L. Ed. 465; *Western Maryland Ry. Co.* v. *Commissioner*, 4 Cir., 33 F. (2d) 695."

The petitioner contends that its subsidiary, the Northern Pennsylvania Power Company carried forward the corporate identity of the North Penn Power Company and the Susquehanna County Power and Light Company and succeeded by operation of law to their rights and liabilities when it absorbed these

companies in accordance with the provisions of the law of Pennsylvania under which the transactions were consummated.

III.

The Transactions by Which the Northern Pennsylvania Power Company Succeeded to the Assets and Liabilities of the North Penn Power Company and the Susquehanna County Power and Light Company Were, Under the Law of Pennsylvania, Strict Mergers.

In 1926 when the petitioner's subsidiary, the Northern Pennsylvania Power Company absorbed the North Penn Power Company and the Susquehanna County Power and Light Company, two forms of transactions were authorized under the laws of Pennsylvania by which the assets and franchises of one corporation might be taken over by another. One course of procedure, sometimes referred to in the Pennsylvania cases as the "long form merger," was provided for by the Act of May 3, 1909, Title 15, Purdon's Pennsylvania Statutes, Section 421, *et seq* (Appendix A *infra* p. 55). The other form of procedure, sometimes referred to in the Pennsylvania cases as the "short form merger," was provided for by Section 23 of the Act of April 29, 1874, as amended, Title 15, Purdon's Pennsylvania Statutes, Section 595. (Appendix B *infra* p. 58).

The "short form merger" provided for by the Act of April 29, 1874, as amended, was followed in the transactions by which the Northern Pennsylvania

Power Company absorbed the North Penn Power Company and the Susquehanna County Power and Light Company. Section 23 of the Statute provides in part that any corporation, with the consent of its stockholders, is entitled:

> "* * * to sell, assign, dispose of and convey to any corporation created under or accepting the provisions of this Act, its franchises and all of its property, real, personal and mixed and that thereafter such corporation shall cease to exist and that the said property and franchises not inconsistent with this Act shall thereafter be vested in the corporation so purchasing as aforesaid * * *."

The Circuit Court of Appeals for the Second Circuit in its opinion in this case sustained the contention of the Commissioner of Internal Revenue that in Pennsylvania in 1926 a technical merger could only be effected by complying with the provisions of the Act of May 3, 1909, for the reason that the provisions of that Act alone imposed liability by operation of law upon the successor corporation for the debts and liabilities of the absorbed corporation. Moreover, the Circuit Court of Appeals for the Second Circuit found that a transaction consummated in accordance with the provisions of the Act of 1874, as amended, constituted a sale and that the successor corporation did not succeed by operation of law to the debts and liabilities of the predecessor corporation. With this holding the petitioner cannot agree since it is believed that the same is not a correct interpretation of the law of Pennsylvania.

A discussion of the proper construction to be placed upon provisions of Section 23 of the Act of 1874 logically divides itself into several parts.

A. General Definition of the Term "Merger."

In order to determine whether or not the transactions by which the Northern Pennsylvania Power Company acquired the assets and liabilities of the two affiliated companies was a merger, it will be helpful to define the term as used by the courts.

There is a definite distinction between a "consolidation," "merger" and "sale" although the same has not always been observed by the legislatures in drafting statutes or by the courts in writing opinions. This fact has resulted in considerable confusion.

A *"consolidation"* is a combination of two or more corporations by which the property, rights and privileges and franchises of all the consolidating corporations are united in a single new corporation, the consolidating corporations losing their separate corporate identities. 15 *Fletcher Cyclopedia Corporations* (Permanent Edition), Section 7041, pp. 6-8.

A *"merger"* is the absorption of one or more corporations by another, the former ceasing to exist and the latter retaining its corporate identity with the added capital, franchises and powers of the merged corporation or corporations. "It is the uniting of two or more corporations by the transfer of property to one of them, which continues in existence, the others being merged therein." 15 *Fletcher Cyclopedia*

Corporations (Permanent Edition), Section 7041, pp. 7-8.

A "*sale*" is a transfer of property for a consideration, both the buying and selling corporations retaining their corporate existence. "Where there is a mere sale or transfer of the assets to another corporation a new corporation is not created, and the respective companies still remain distinct legal entites." 15 *Fletcher Cyclopedia Corporations* (Permanent Edition), Section 7044, p. 16.

B. PENNSYLVANIA CASES HOLD THAT A MERGER MAY BE ACCOMPLISHED UNDER THE PROVISIONS OF SECTION 23 OF THE ACT OF 1874, AS AMENDED.

Bearing in mind the distinction between a "merger," a "consolidation" and a "sale," let us proceed to an analysis of the Pennsylvania statutes and the decisions interpreting the same.

The Act of May 3, 1909, does not provide for a "*merger*" at all and only provides for a "*consolidation.*" It provides that a joint agreement shall be entered into, setting forth the "name of the *new* corporation," * * * "the *first* directors and officers," * * * "the manner of *converting the capital stock of each of said corporations into the stock of the new corporation,*" and that "new letters patent" shall be issued thereon. It is clear, therefore, that although the Act of 1909 uses the terms "merger and consolidation" it effects a combination of two or more corporations into a single *new corporation*

for which new letters patent must be issued and the stock of which must be substituted for the stock of the old corporations. Since the Act creates a *new corporation* in place of all the old corporations combined thereunder and does not provide for the *survival of one of the old corporations* with the added franchises, powers and property of the others, it is clear that this is a *"consolidation"* statute and not a *"merger"* statute.

The Act of April 29, 1874, as amended definitely provides a procedure by which the property, rights and franchises of one corporation may be united with those of another, the latter continuing its existence while the former, by operation of the statute, ceases to exist.

The Act of 1909 and the Act of 1874, as amended, were both repealed by enactment of the new Corporation Law of 1933 which substituted therefor new statutory provisions for mergers and consolidations clearly distinguishing between the two.

In *Pennsylvania Corporation Laws of 1933*, the following annotation by E. Russell Stockley, Esquire, Special Deputy Attorney General and draftsman of the Act of 1933, appears on page 104 as a note to Sec. 901:

> "As used in the Act of 1909, the words 'consolidate' and 'merge' were used synonymously, whereas such words technically, have different meanings. In a merger, only one of the constituent corporations survives whereas the others lose their identities; while in a consolidation all

> the constituents lose their identities and a new corporation springs up in their place. This Act, (referring to the 1933 Act) like the Uniform Act and the Acts of the states above listed, makes a clear distinction between a merger and a consolidation."

Mr. Stockley again in the last two sentences of his last two "comments" Section 311 of the *Pennsylvania Corporation Laws of 1933*, page 39 says:

> "* * * This provision of the Act provides a statutory procedure for the voluntary sale of the corporation property and assets, executing its franchises, and makes no change in the existing law. *It does not, however, authorize or have the effect of a merger similar to that formerly authorized by Section 23 of the Corporation Act of 1874 as amended.*" (Italics added.)

As has been pointed out, the Act of 1874, as amended, was the only law of Pennsylvania under which a merger could be effected prior to the new Corporation Law of 1933. If the transactions by which the Northern Pennsylvania Power Company absorbed the North Penn Power Company and the Susquehanna County Light & Power Company had taken place after the Corporation Act of 1933 became effective and the merger had been consummated under the provision of Article IX thereof, there would be no question but that the transactions were statutory mergers. The transactions by which the Northern Pennsylvania Power Company absorbed its two affiliates in question, however, took place in accord-

ance with the Act of 1874, as amended. The result of such a transaction has been repeatedly held by the courts of Pennsylvania to be a "merger."

In *Bly* v. *White Deer Mountain Water Co.*, 197 Pa. 80, the Supreme Court of Pennsylvania held that certain utility corporations could carry on their business only in the town, borough, city or district in which they were located and not in territory adjacent thereto. The practical result of this decision was that it became necessary for some utility companies to form a different corporation in other municipal districts where present or future operations might be contemplated. It being important to construct a separate operating plant in each district for which a charter had been granted, a plan was involved to unify the corporations so that the business could be carried on in substantially the same manner as if the charter of one corporation authorized it to operate in all the districts. The Legislature had prescribed two methods by which such unification might be effected: (1) merger under the Act of April 29, 1874, as amended or (2) consolidation under the Act of 1909.

As the effect of the Act of 1874, as amended, was to preserve the identity or existence of one corporation it offered certain advantages over the creation of a new corporation under the Consolidation Act of 1909, and was therefore largely employed. The two methods became distinguished by the respective descriptive, but untechnical names of "short form" and "long form" merger.

In *Pennsylvania Utilities Co.* v. *Public Service Commission,* 69 Pa. Sup. Ct. Rep. 612, Judge Kephart, now Chief Justice of the Supreme Court of Pennsylvania, made the following statement concerning the necessity of unifying the charters of such utility companies and recognized the fact that the merger resulting under the Act of 1874, as amended (which he called the Purchase Act of 1876, presumably because one of the steps in effecting the merger took the form of a sale) p. 614:

> "The question presented by this and a number of other appeals now before the court is of considerable importance to utility companies in the Commonwealth. After the decision in the case of Bly *v.* White Deer Mt. Water Company, 197 Pa. 80, there was a great effort by certain utilities to secure charters for the municipal districts they deemed necessary to their present and future plan of development. These concerns found it impossible, because of their great economic waste, to construct separate operating plants in each of the districts for which charters were secured. The legislature had supplied a way by which the charters might be unified and very much the same result obtained as though a charter for more than one district had been permitted. The Purchase Act of 1876 was largely employed. See Hey *v.* Springfield Water Co., 207 Pa. 38; Commonwealth *v.* Lumber City Water Co., 225 Pa. 317; Greensburg Boro. *v.* Westmoreland Water Co., 240 Pa. 485; and a list of authorities there referred to. *As a legal consequence the purchase act differs but little from the merger act which is*

used to some extent to consolidate companies." (Italics added.)

In *York Haven Water and Power Company et al.* v. *Public Service Commission of Pennsylvania et al.*, 287 Pa. 241, 134 Atl. 419, the question before the Court concerned the right of an electric light, heat, and power company to merge with an hydro-electric or water power company. The Court held that the merger could not be accomplished until the right of the hydro-electric company to furnish water to the public (which was not common to both companies) was legally discarded and in the course of the opinion Kephart, *J.*, said:

> "There are two forms of consolidation in Pennsylvania, a short and a long form merger. These are accomplished by the Act of 1876, as amended, and the Act of 1909. The Act of 1876, P. L. 33, as amended, provides that such sale may take place if the 'franchises are not inconsistent' with this act. And the merger Act of 1909, P. L. 408, permits consolidation between corporations 'transacting the same or similar lines of business.' * * * A sale or merger, under the Act of 1876, with its amendment, or the Act of 1909, which is practically the same, cannot take place until the company legally discards the offending power."

The Act of 1876 mentioned by the Court is the Act of 1874, as amended by the Act of April 17, 1876,

Section 5 and the Act of June 2, 1915, under which the transactions in the case at Bar were effected.

The language used by Judge Kephart in *Pennsylvania Utilities Company* v. *Public Service Commission, supra,* shows the confusion in the use of terms to which the courts fall prey, but indicates the recognition by the Supreme Court of Pennsylvania that transactions effected under the Act of 1874, as amended, and under the Act of 1909 are "practically the same."

As the above discussion shows, the Pennsylvania cases have held that the Act of 1874, as amended, is a merger statute and that transactions consummated thereunder are known in Pennsylvania as "short form mergers" as distinguished from "long form mergers" effected under the provisions of the Act of 1909.

Not only have the Pennsylvania courts recognized that the Act of 1874, as amended, is a merger statute, but transfers accomplished in accordance with the provisions of that Act meet all of the tests of a strict merger as set forth in the case of the *American Gas and Electric Co.* v. *Commissioner,* 2 Cir., 85 F. (2d) 527, where the Circuit Court of Appeals for the Second Circuit stated as an essential of such a merger as would entitle the successor corporation to claim deductions of the unamortized bond discount and expense of the merged corporation, that the merged corporation shall cease to exist and that the successor corporation must, by operation of law, become responsible for the liabilities of the merged corporation.

C. A Transaction Consummated Under the Act of 1874, as Amended, is a Merger and Not a Sale Since the Transferor Corporation Ceases to Exist.

Section 23 of the Act of 1874, as amended specifically provides that a corporation which sells, assigns, or conveys to another corporation its franchises and property shall thereafter "*cease to exist* and * * * the said property and franchises not inconsistent with this Act shall therefore be vested in the corporation so purchasing as aforesaid * * *."

In this connection the Circuit Court of Appeals for the Third Circuit in the case of *Metropolitan Edison Co.* v. *Commissioner*, 98 F. (2d) 807, at page 810 of the Reports said:

> "Both the short and long form statute are equally explicit in providing that the absorbed corporation ceases to exist. It would, therefore, appear that the effect of a merger under both statutes is the same in this respect."

In contending that the transactions in question were sales the Respondent may rely upon the following statement of Kephart, *J.*, in *In Re Buist Estate*, 297 Pa. 537, 147 Atl. 606:

> "Care should be taken to distinguish consolidations from proceedings under the Act of 1876, P. L. 33, often referred to as a 'short form merger' (See York Haven W. & P. Co. v. Pub. Ser. Com., 287 Pa. 241); its operation in reality effects a sale of all the company's assets."

The question before the Court in the above case involved the rights of a life tenant, receiving the income from a trust, to certain stock received by the trust upon the merger of a number of banking institutions into the Philadelphia National Bank under the Act of Congress empowering national banks to consolidate. All that Kephart, *J.*, intended to point out in that portion of his opinion above quoted was that the Act of 1876, amending the Act of 1874, did not provide for consolidations but only for mergers which were effected through a transfer by one corporation to another of "its franchises and all its property, real, personal and mixed,"—the transaction taking the form of a sale, thereby distinguishing such a transaction from a consolidation of national banks under the Act of Congress which is not accomplished through the form of a sale. The observation made by Kephart, *J.*, with reference to the Act of 1874, as amended, should not be taken as a holding by the Supreme Court of Pennsylvania that the Act does not effect a merger but only that a transaction under the Act effects a merger by employing as one of the steps a form of "sale."

In 8 *Thompson on Corporations*, Third Edition, Section 6012, page 66, the learned author says:

> "* * * In a merger of two or more corporations, one of the merged corporations survives; that is, the merger consists in the uniting of two or more by the transfer of all the property to some one of the existing corporations, which continues its existence, while the others are

swallowed up by or merged in the one that exists. And in this respect it differs from a consolidation, wherein * * * all the corporations terminate their existence and become parties to a new one. *The true test as to whether or not there has been a merger, is as to whether the existence of one of the corporations has been preserved and the other has ceased to exist.*" (Italics added.)

In Section 6019, at page 78, the author further says:

"* * * But, as already noticed, and as judicially held, consolidation may be effected by the purchase of all the property and franchises of one corporation by another * * *"

In 15 *Fletcher Cyclopedia Corporations* (permanent edition), Section 7044, pp. 16-17, the author says:

"* * * if the coming together of two corporations under the authority of law be in fact consolidation * * * it is of no consequence by what name the act is characterized nor is it of any consequence by what steps the result has been effected, *and one of those steps may take the shape of bargain and sale.*" (Italics added.)

If it is borne in mind that a merger may be accomplished in the form of a bargain and sale, a great deal of the confusing language in the cases is explained. It is submitted that the contention of the Respondent and the decision of the Circiut Court are based upon the failure to observe this fact. It is true that under the Pennsylvania "short form" merger, one step takes the form of a sale. The

important point to note, however, is that the "sale" under the Pennsylvania Law is merely a means of effecting the merger of corporations. That this fact is important is shown by the case of *Bassick* v. *Commissioner of Internal Revenue*, 85 Fed. (2d) 8 (C. C. A. 2) (certiorari denied 299 U. S. 592), where the Court said: "For Income Tax purposes, the component steps of a single transaction cannot be treated separately."

In *Chicago Santa Fe and California Railway Co.* v. *Ashling*, 160 Ill. 373, 380, 381, 43 N. E. 373-375, the Chicago and St. Louis Railway Co. transferred all of its properties and franchises by deed of conveyance to the appellant. The question before the Court was whether this transaction which was in the form of a sale was not in fact a "consolidation." In holding that the transaction was a "consolidation" and that the defendant was liable for the torts of its predecessor from which it purported to "buy" assets, the Court said:

> "* * * It is true, that what was done must be considered in order to determine whether there was a consolidation or not; but we must look to the results accomplished, rather than to the means, steps or procedure by which those results have been attained.
>
> "* * * *There is no magic in words. Merely calling the transaction a purchase and sale would not prevent it from being a consolidation.* It cannot be supposed, from the nature of this transaction, that it was expected that the St.

> Louis Company should continue its active corporate existence after divesting itself of all its property, corporate rights and franchises and stockholders." (Italics added.)

In *Continental Trust Company* v. *Toledo St. L. & K. C. R. Co.*, 82 Fed. 642, 652, Mr. Chief Justice Taft, then Circuit Judge, considered the effect of an Illinois Statute which provided:

> "That all railroad companies now organized, or hereafter to be organized under the laws of this state, which now or hereafter may be, in possession of and operating in connection with or extension of their own railway lines any other railroad or railroads in this state, or in any other state or states, or owning and operating a railroad which connects at the boundary line of this state with a railroad in another state, *are hereby authorized and empowered to purchase and hold in fee simple* or otherwise and to use and enjoy, the railway property, corporate rights and franchises of the company or companies owning such other road or roads upon such terms and conditions as may be agreed upon between the directors and approved by the stockholders," etc. (Italics added.)

Concerning the effect of this statute the learned Judge said:

> "Although this act uses the word 'purchase,' it plainly contemplates consolidation, and this is the holding in Illinois * * *."

The authorities clearly support the proposition that either a merger or consolidation may be accomplished even though one of the steps in effecting the merger may be a sale. The true test in determining whether or not a certain transaction between two or more corporations constitutes a merger is whether the existence of one of the corporations has been preserved and the others have been swallowed up by or merged in the one that continues in existence.

The "short form" merger under Pennsylvania law meets all the essential legal requirements of a merger, which was defined by Judge Augustus N. Hand in *Cortland Specialty Co. et al.* v. *Commissioner of Internal Revenue,* 60 Fed. (2nd) 937 (1932) (Cert. Den. 288 U. S. 599, 77 L. Ed. 975), as follows:

> "Reorganization, merger, and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more. * * * *A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist and the merging corporation alone survives.* A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. * * * A sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside

the objects of merger and consolidation statutes." (Italics added.)

Following the completion of the transfer by the North Penn Power Company and the Susquehanna County Light and Power Company of all of their assets to the Northern Pennsylvania Power Company in accordance with the provisions of the Act of 1874, as amended, the transferor corporations in the case at bar, in accordance with the express provisions of the statute, ceased to exist and were, in fact, dissolved. Of course, as in all cases of merger or consolidation of corporations, the absorbed corporation continues to exist for the purpose of actions pending against it. This is true of an absorbed corporation under the "long form merger statute" of Pennsylvania by the express terms of Section 423 of that Act, although there is no question that the Act of 1909 is a strict consolidation statute. It is likewise true of a merger under the Act of 1874.

Since under the Pennsylvania law the North Penn Power Company and the Susquehanna County Light and Power Company ceased to exist when they were absorbed by the Northern Pennsylvania Power Company under the Act of 1874, as amended, the transaction in each case was a merger and not a sale.

D. As a Result of a Merger Effected Under the Provisions of the Act of 1874, as Amended, a Transferee Corporation Succeeds by Operation of Law to the Liabilities of the Transferor Corporation.

In its opinion in this case the Circuit Court of Appeals for the Second Circuit in coming to the conclusion that the Pennsylvania "short form merger" constitutes a sale and that creditors of the transferor can hold the transferee liable only on principles of fraudulent conveyance and to the extent of the value of assets received, relies upon the case of *Merwine* v. *Mt. Pocono Light & Improvement Co.*, 304 Pa. 517, 156 A. 150.

In that case the appellant had sued to recover damages for personal injuries. The defendant's attorney filed a suggestion setting forth that the property and franchises of the defendant had been conveyed to the Pennsylvania Power and Light Co. in *proceedings under the Act of 1874, as amended;* they alleged that under the Act the defendant had ceased to exist and therefore prayed that the action against it should be abated. Plaintiff filed an Answer and prayed that a Rule be allowed to show cause why the Pennsylvania Power and Light Company should not be substituted as defendant. The Court below denied the prayer of the plaintiff and abated the action.

On appeal, the Supreme Court of Pennsylvania held that determination of the corporate existence of

the defendant company under the Act of 1874, as amended, did not abate the action.

Counsel for the appellant had contended in his brief (page 518 of Opinion) that "The transaction was a merger, not a sale." In considering this contention the Court said at pages 524-525:

> "Although we need not decide the point, it is proper to call attention to the fact that the pleadings indicate that the Pennsylvania Power & Light Company took over the property of defendant under circumstances warranting a finding, upon evidence produced to support the allegations in the pleadings, *that the transaction between the two corporations was in reality a merger, or such union of interests as, in law, caused the buying corporation to assume defendant's obligations.* There is much to show that the purchase was attended by an intimacy of interest tending to render the transaction, in so far as the Pennsylvania Power & Light Company's interest was concerned, a purchase *cum onere.* For instance, it is averred that, at the time of the commission of the alleged negligent acts on the part of the Mount Pocono Light & Improvement Company, it was affiliated or associated with the Pennsylvania Power & Light Company to the extent that both companies were managed, operated and controlled under the same management and system. It is admitted that the common stock of both companies was owned by the same holding company, and, by defendant's own showing, thirteen of the same persons were officers or directors in both companies. It

> further appears that both companies operated from the same office. Plaintiff states that the business of the Mount Pocono Company was conducted by the agents, servants and employees of the Pennsylvania Power & Light Company; that after the sale, the power company took over and operated the business formerly conducted by defendant; and that the sale was merely a formality giving effect to a union of the companies which had in reality occurred previous to the accident upon which the suit is based." (Italics added.)

Attention is particularly called to that portion of the above statement appearing in italics whereby the court definitely states that a transfer by a corporation (under the procedure prescribed under the Act of 1874, as amended) of its franchises and property to "the buying corporation," with which it is affiliated, is simply a formality and the transfer in reality is a merger of the two companies. All that the Court actually held in the *Merwine* case was that the action brought against the merged subsidiary prior to the merger did not abate, and that if the plaintiff recovered judgment against the Mt. Pocono Company she could "levy where defendant's assets liable for the judgment may be found."

The Circuit Court of Appeals for the Second Circuit stated in its opinion in this case that the transfer of the property of the Mt. Pocono Company to the successor corporation might be set aside as being in fraud of creditors and in that sense only did the successor corporation succeed to the liabilities of the absorbed corporation. This, however, is not the procedure under the law of Pennsylvania.

A Pennsylvania corporation which has acquired the assets of another corporation in accordance with the provisions of the Act of 1874 as amended, succeeds to the liabilities of the transferor, not by reason of any application of the doctrine of fraudulent conveyances, but by reason of the fact that in Pennsylvania such liability is, by operation of law, an inherent part or consequence of a merger.

The Statute of 13 Elizabeth, Chapter 5, dealing with fraudulent conveyance applies to colorable sales made for the purpose of delaying or hindering creditors and it declares such sales to be "utterly void." This Statute has no bearing on mergers or consolidations which are authorized by statute. The transaction in the *Merwine* case and in the case at bar were specifically authorized by the Act of 1874, Section 23, as amended and are therefore lawful and not "utterly void" under the Statute of Elizabeth.

The Statute of Elizabeth may apply to ordinary sales of corporate property such as those referred to in the following cases:

Ringler v. *Atlas Portland Cement Co.*, 301 Pa. 176, 151 A. 815;

Mount Union Borough v. *Kunz*, 290 Pa. 356, 139 A. 118;

Maxler v. *Freeport Bank*, 275 Pa. 510, 119 A. 592;

Koehler v. *St. Mary's Brewing Co.*, 228 Pa. 648, 77 A. 1016;

Carr v. *Rochester Tumbler Co.*, 207 Pa. 392, 56 A. 945.

In *Montgomery-Web Company* v. *Dienelt,* 133 Pa. 585, 19 A. 428, the Court held an ordinary sale of property by a corporation to be void, just as "in the case of an individual, a transfer to his wife or his agent, or anybody who should merely represent himself under another name, would be unquestionably void against creditors."

In cases of ordinary sales in fraud of creditors the creditors may (*a*) pursue the assets in the hands of the new company through judgment against the old company on theory that the sale is void or voidable, or (*b*) by proper proceedings fasten a constructive trust as to such assets on the new company as Trustee (*Halpern* v. *Grabosky,* 296 Pa. 108, p. 112, 145 A. 834), or (*c*) file a bill in equity to discover assets and impose liability upon the theory that equity regards the property as a trust for the payment of existing debts, and will follow it on behalf of creditors until it gets into the hands of innocent purchasers for value (*Montgomery-Web Company* v. *Dienelt,* 133 Pa. 585, p. 596, and *Mt. Union Borough* v. *Kunz,* 290 Pa. 356, p. 362).

In the latter case while the transfer of the water works was made under the Act of 1874, Section 23, as amended, the transaction was an *ordinary sale,* not a *merger,* as the purchase price was $60,000 in cash and other considerations. There was no amalgamation of interests, as there must be in a merger; the old owners divorced themselves from the business.

The Act of 1874, as amended, authorizes out-and-out sales, like the water works sale, or mergers

like that in the *Merwine* case and in the case at bar where the North Penn Power Company and the Susquehanna County Light and Power Company transferred all of their property rights and franchises to the Northern Pennsylvania Power Company in exchange for stock so that the interests of the old companies were amalgamated and merged with those of the surviving corporation. The old companies not only ceased to do business, but by the very nature of the transfer ceased to exist. In so doing the Northern Pennsylvania Power Company took the property of the transferor corporation *cum onere* (*Merwine* v. *Mt. Pocono Land Improvement Company* case, *supra*), although an action pending against the old companies would not abate.

Being a merger under the Pennsylvania law, the transfer of the assets of the absorbed corporations to the Northern Pennsylvania Power Company was not void, having been accomplished in accordance with the statutory provisions of Section 23 of the Act of 1874, as amended. There could be no occasion to file a bill in equity to discover assets, as in the case of a fraudulent conveyance, since there was no concealment requiring the discovery. The transaction was entirely open and above-board and the facts readily ascertainable by all parties in interest.

The Supreme Court of Pennsylvania has held that the remedy of creditors of a *merged* corporation is to follow the assets into the hands of the surviving corporation. Thus in *Berkovitz's Appeal*, 319 Pa. 397, at page 407, the Court said:

> "* * * we have also decided in other cases that creditors of one corporation may follow the property or assets of such corporation into a new corporation *where there has been a merger*, or,

in cases of fraudulent transfer. See Halpern *v.* Grabosky, 296 Pa. 108, 111; Merwine *v.* Mt. Pocono, 304 Pa. 517, 522; Delphia Knitting Mills Co. *v.* Richards, 62 Pa. Superior Ct. 9, 12." (Italics added.)

As the court in the above case pointed out, where there is a merger the creditors of one corporation may follow the property or assets of that corporation into the new corporation. In this respect the remedy is the same as that afforded creditors in the case of a fraudulent transfer. Attention, however, is called to the fact that while the remedial procedure may be the same in the case of a merger as in the case of a fraudulent transfer, the basis for the remedy in one is not the same as the basis for the remedy in the other. A creditor in the case of a merger is given certain remedies as a legal incident of the merger, namely, that the successor corporation is liable for the debts of its predecessor while in the case of a fraudulent transfer by way of sale or otherwise, a creditor is granted equitable relief. In the case of a merger there is no necessity of resorting to equitable principles.

In the case of *Merwine* v. *Mt. Pocono Land Improvement Company, supra,* the Court said that the plaintiff having secured judgment could "*levy* where defendant's assets liable for the judgment may be found." The direction of the Court to "levy" could only mean one thing—the issuance of a writ of *fieri facias* and the seizure by the Sheriff of the property owned by the Mt. Pocono Company and now in the hands of the Pennsylvania Power and Light Company. The Supreme Court of Pennsylvania made this perfectly clear in *Weinroth* v. *Homer B. and L. Association,* 310 Pa. 265, p. 270, where, in referring

to the *Merwine* case it said: "The court there directed plaintiff, if he recovered judgment, to pursue the property of defendant in possession of the merged company." Since the transfer of the property of one corporation to another corporation under the provisions of the Act of 1874, as amended, is authorized by statute, the property upon its transfer is, in fact, the property of the transferee or surviving corporation and cannot either in law or in equity be considered the property of the old corporation. Therefore, to say that upon a merger a creditor of the transferor corporation can pursue the property formerly owned by it into the hands of the merged company can only mean that the merged company acquires the property of a transferor corporation subject to all of its debts and liabilities.

In the case of *Lansdowne Bank & Trust Company (In re Harr)*, 323 Pa. 380, 186 A. 120, the Supreme Court of Pennsylvania said at page 384:

> "The well settled principle applies that where one corporation purchases the business and assets of another, it succeeds to all the other's rights and is bound as well by all its obligations: *Maxler* v. *Freeport Bank et al.*, 275 Pa. 510; *Buist's Estate*, 297 Pa. 537."

There can be no doubt that under the Pennsylvania law when one corporation by merger succeeds to the assets of another, it likewise succeeds to all of the other's rights and is bound as well by all its obligations.

As has already been pointed out, a merger under the Act of 1874, Section 23, as amended, has been considered by the Supreme Court of Pennsylvania as being practically the same as a consolidation under the Act of 1909.

The Act of 1909 (Title 15 Purdon's Statutes, Sections 421-425) contains the following provision:

> "Section 423. Effect of merger * * *
>
> "* * * Provided, That all rights of creditors and all liens upon the property of each of said corporations shall continue unimpaired, limited in lien to the property affected by such liens at the time of the creation of the same, and the respective constituent corporations may be deemed to be in existence to preserve the same; and all debts not of record, duties, and liabilities of each of said constituent corporations shall thenceforth attach to the said new corporation, and may be enforced against it to the same extent and by the same process as if said debts, duties, and liabilities had been contracted by it."

The effect of the decisions in the *Merwine* and other cases above mentioned is to make the law with respect to the rights of creditors of merged corporations identically the same as the statutory rights of creditors of constituent corporations in consolidations effected under the Act of 1909.

It is a general proposition that where a corporation is absorbed by another and transfers its assets in consideration for the shares of stock in the transferee corporation the latter is liable for the debts and liabilities of the former, regardless of whether the transaction takes the form of a strict merger or not. See 15 *Fletcher Cyclopedia Corporations* (Perm. Ed.) Section 7127, 15 A. L. R. 1112, 30 A. L. R. 558, 39 A. L. R. 143. The Pennsylvania cases support this proposition.

Contrary to the opinion of the United States Circuit Court of Appeals for the Second Circuit rendered

in this case, petitioner submits that the law of Pennsylvania gives creditors of a merged or constituent corporation a plain, adequate and complete remedy at law against the surviving or new corporation for the debts and obligations of the absorbed corporation. However, such a right is not a *sine qua non* of a technical merger or consolidation for the reason that it is generally held that if a creditor does not have an adequate remedy at law he may proceed in equity to enforce his rights against merged or constituent corporations. See Section 7170-7171 of *Fletchers Cyclopedia Corporations* (Perm. Ed. Vol. 15).

Whether or not the creditors of a merged or consolidated corporation have the right to enforce their claims at law or in equity is immaterial so long as the successor corporation remains liable for the same. Whether such liability be characterized as an assumption of liability by operation of law or upon the application of equitable principles is immaterial. It is not from what the procedure is called that the assumption of liability flows, but it is the result of the procedure.

Where, therefore, a Pennsylvania corporation merges with or absorbs another corporation, each having substantially the same stockholders, the transfer of the assets from the old corporation to the continuing corporation carries with it by *operation of law* the liability for the debts of the old corporation even though there is no contract or agreement by the continuing corporation to assume such debts. The assumption by operation of law of such liability completely meets the test prescribed in the case of the *American Gas and Electric Company* v. *Commissioner*, 85 Fed. (2d) 527.

In the argument which has here been presented the

petitioner is sustained by the Circuit Court of Appeals for the Third Circuit in passing upon the identical question in the case of *Metropolitan Edison Company* v. *Commissioner,* 98 Fed. 2d 807, and in the case of *The Pennsylvania Water and Power Company* v. *Commissioner,* 98 Fed. 2d 812. In the former case the Court said on page 810 of the Reports:

> "We are convinced that the transactions, by means of which the petitioner absorbed the subsidiaries here involved, partook of all of the essential elements of a merger (Chicago, S. F. & C. Ry. Co. *v.* Ashling, *supra*), and that the petitioner is entitled to the deduction claimed for 1928. Cir., 85 F. 2d 527; *New York Cent. R. Co.* v. *Commissioner,* 2 Cir., 79 F. 2d 247, certiorari denied 296 U. S. 653, 56 S. Ct. 370, 80 L. Ed. 465; *Western Maryland Ry. Co.* v. *Commissioner,* 4 Cir., 33 F. 2d 695; *American Gas & Elec. Co.* v. *U. S.,* 17 F. Supp. 151, Ct. Cl."

IV.

The Transactions in the Case at Bar by Which the Northern Pennsylvania Power Company Acquired the Assets and Liabilities of Other Companies Involve a Change in Form Only and Therefore the Deductions Should be Allowed Irrespective of the Technical Nature of the Transactions.

Since the Northern Pennsylvania Power Company was merged with the North Penn Power Company and the Susquehanna County Light and Power Company under the Pennsylvania Act of 1874 as amended, petitioner contends, for the reasons hereinabove set forth, that the deductions claimed for the unamortized

sorbed companies never sustained or took any loss on account of the unamortized debt discount and expense since such loss could only arise when the bonds were retired. The bonds were actually retired by the Northern Pennsylvania Power Company and unless it is entitled to take the loss, no one obtains the benefit thereof contrary to the express intention of Congress that a corporation which sustains a loss shall be entitled to deduct the same in computing its net taxable income.

The decisions in the cases of *Western Maryland Ry. Co.* and *New York Central R. Co. supra,* sustain the position of the petitioner.

In *Western Maryland Railway Co.* v. *Commissioner,* 33 Fed. (2d) 695 (C. C. A. 4), the question was whether the Western Maryland Railway Co. was entitled to amortize and deduct discount on bonds issued by its predecessor which consolidated with seven subsidiaries, all of whose stock it owned and whose property it operated as its own. The Interstate Commerce Commission required that the unamortized discount be carried on the balance sheet of the consolidating company and amortized over the remaining life of the bonds. The Board of Tax Appeals denied the deduction and the Railway Company appealed.

In reversing the decision of the Board the Court said:

> "We come then to the second question in the case: Has the right to deduct the amortized portion of the discount been lost by reason of the reorganization of the corporation that sold the bonds and the taking over of its assets and liabilities by the consolidated company? We think not. In the first place, it is perfectly clear that, al-

though there has been a reorganization and although the consolidated corporation is a distinct legal entity from those whose places it has taken, nevertheless in all of its essential relationships, it occupies exactly the same position which they occupied. Its management is the same, its assets are the same, its stockholders are the same, and its obligations are the same, except that the floating indebtedness of the old corporation has been taken up by the first preferred stock of the new, a change which might have been effected by the old corporation without reorganization, and which manifestly can have no bearing upon the matter of bond discount. In other words, the consolidated corporation has stepped into the place of the corporation which issued the bonds, and occupies the same relationship towards them that it occupied. It has received no consideration for its agreement to pay them except the assets of the old corporation which have been transferred to it. It has the same property as the old corporation, owes the same bonded debt, and is bound to pay it in the same way. The Interstate Commerce Commission required that the unextinguished discount be carried on the balance sheet of the company and that same be amortized by charge against income for the remaining life of the bonds, just as though no reorganization had taken place; and, the deduction is to be allowed as a basis for rate making and for determining the rights of the government under the recapture clause of the Transportation Act, there is no reason why it should not be allowed in determining the basis of taxation also. *After all, while there is a*

technical legal difference between the old and the new corporations, they are the same as a practical matter, both holding the same property and representing the same ownership, and it is a settled principle that 'courts will not permit themselves to be blinded or deceived by mere forms of law but, regardless of fictions, will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require.' Chicago, Milwaukee & St. Paul R. Co. *v.* Minneapolis Civic Assn., 247 U. S. 490, 501, 38 S. Ct. 553, 557 (62 L. Ed. 1229); Southern Pac. Co. *v.* Lowe, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142; Gulf Oil Corporation *v.* Lewellyn, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133.

"*The rule just stated is of peculiar importance in tax cases; for, unless the courts are very careful to regard substance and not form in matters of taxation, there is grave danger on the one hand that the provisions of the tax laws will be evaded through technicalities and on the other that they will work unreasonable and unnecessary hardship on the taxpayer.* It is instructive to note the many tax cases decided in recent years in which the courts have not hesitated to ignore corporate forms, and to decide the questions involved in the light of what the parties have actually done, rather than on the basis of the forms in which they have clothed their transactions. See Weiss *v.* Stearn, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001, 33 A. L. R. 520; U. S. *v.* Phellis, 257 U. S. 156, 42 S. Ct. 63, 66 L. Ed. 180; Eisner *v.* Macomber, 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521, 9

A. L. R. 1570; Gulf Oil Corp. *v.* Lewellyn, *supra;* Alpha Portland Cement Co. *v.* U. S. (C. C. A. 3d), 261 F. 339; Appeals of A. J. Siegel, 4 B. T. A. 186; Appeal of H. E. Brubaker, 4 B. T. A. 1171. *We think, therefore, that as the new corporation, while technically a distinct legal entity, is to all practical intents and purposes a mere continuation of the old, it is entitled to the same deduction on account of amortized bond discount that the old corporation would have been entitled to, if the reorganization had not taken place."* (Italics added.)

It is important to note from the above statement that, although there was a technical legal consolidation in that case, the Court did not base its opinion upon that fact, but upon the fact that the consolidation effected a change in form only and that although the consolidating corporation was technically a different corporation from the issuing corporation, it was "to all practical intents and purposes a mere continuance of the old" and "entitled to the same deduction on account of bond discount that the old corporation would have been entitled to." Indeed the Court continued:

"In the second place, we think that, irrespective of the practical identity of the old and new corporations, petitioner is entitled to the deductions claimed because of having taken over the assets and assumed the liabilities of the old corporation which was unquestionably entitled to it. Among the liabilities of the old corporation as shown by its books was the bond issue; and

among its assets was the amount set up as bond discount, against which was charged each year an amortized portion thereof. In taking over the liabilities and assets, the new corporation took the place of the old as to both of these items. As has been said, bond discount is really deferred interest payable at the maturity of the bonds. When, therefore, the new corporation assumed the obligations of the old, its agreement to pay the bonds at maturity embraced necessarily the agreement to pay this deferred interest, which is included in the face of the bonds. As the new corporation is bound to pay this, there is no reason why it should not amortize it in the same way as the old corporation."

The decision of the Court in the Western Maryland case was approved by the Circuit Court of Appeals for the Second Circuit in *New York Central Railroad Co.* v. *Commissioner*, 79 Fed. (2d) 247, in which the Court said:

"In Western Maryland R. Co. *v.* Commissioner, 33 F. (2d) 695 (C. C. A. 4), it was held that a consolidated corporation steps into the place of the constituent corporations and is entitled to deduct amortized discount on bonds issued by them. We think this decision is sound and should be followed in the case at bar. The consolidated corporation does not succeed to the rights and liabilities of the constituent companies as a purchaser but as a successor by operation of law. See Cortland Specialty Co. *v.* Commissioner, 60 F. (2d) 937, 939 (C. C. A. 2); Commissioner *v.* Oswego Falls Corp., 71 F. (2d) 673.

676 (C. C. A. 2). The assets of the consolidated corporation have the same cost basis as they had when held by the old companies and are subject to the lien of the bond issues. Hence the consolidated corporation will suffer a loss when it pays the bonds at par, and the regulations as to spreading this loss over the life of the bonds should apply. They do not in terms confine discount deductions to the issuing corporation, and should not be construed to do so. If the new corporation cannot take the deduction, no one can, for the old companies sustained no loss when the consolidation was affected. As already stated, the subject of amortization is the difference between the cash realized on the bonds and their par value. This difference the consolidated corporation will pay when the bonds mature, and this expenditure it should be allowed to anticipate by yearly amortization during the life of the bonds in order more clearly to reflect its income.

"* * * * * * *

"The petitioner also claims to be entitled to deduct in each of the taxable years the amount of $29,518.97 discount on bonds of predecessor companies which were merged with the petitioner. The principles above discussed as applicable in case of consolidation are equally applicable to merger. * * *." (Page 250 of opinion.)

Respondent takes the position that the Northern Pennsylvania Power Company, in assuming the bonds of its affiliates, agreed to pay the full face value of the bonds in consideration of the assets being

transferred to it, and that, for this reason, the company received full consideration for its promise to pay the bonds and has suffered no discount.

This argument was effectively answered by the Circuit Court of Appeals for the Fourth Circuit in *Western Maryland Railway Co.* v. *Commissioner,* 33 F. (2d) 695, where the Court said at page 698:

> "It is argued, however, that the new corporation has agreed to pay the full face of the bonds in consideration of the assets transferred to it, and that, for this reason, it has received full consideration for them and has suffered no discount. But this by no means follows. The fact that bonds have been sold at a discount presupposes that the interest rate which they carry is less than the prevailing rate at the time of sale; and it is but fair to assume that this has been taken into account in the price paid or the terms agreed upon for the transfer of the corporate assets. The matter takes care of itself in the case of a reorganization such as this; for it is manifest that, as the discount was mirrored in the affairs of the old corporation by the fact that its actual assets were that much less than they would have been had the discount not been effected, it is mirrored in exactly the same way when the assets pass into the hands of the reorganization. As a man cannot lift himself by his own bootstraps, so a corporation cannot, by a mere process of reorganization, increase its actual assets or wipe out the fact that it is bound to pay bond discount which is in reality deferred interest."

The respondent takes the same position in this case as he did in the case of *New York Central R. Co.* v. *Commissioner,* 79 F. (2d) 247, to the effect that deductions for losses, being personal to the taxpayer who actually sustained them, only the corporation actually issuing the bonds may deduct unamortized debt discount and expense. This contention was rejected and effectively answered by the court in the *New York Central R. Co.* case, *supra,* in its opinion on page 249 of the Reports, as follows:

> "The Commissioner argues that allowable deductions are personal to the taxpayer and cannot be transferred to or used by another. But the cases which announce this doctrine deal with losses sustained by a predecessor and sought to be deducted by a successor. New Colonial Ice Co. *v.* Helvering, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348; Brandon Corp. *v.* Commissioner, 71 F. (2d) 762 (C. C. A. 4); May Oil Burner Corp. *v.* Commissioner, 71 F. (2d) 644 (C. C. A. 4); Cem Securities Corp. *v.* Commissioner, 72 F. (2d) 295 (C. C. A. 4); Athol Mfg. Co. *v.* Commissioner, 54 F. (2d) 230 (C. C. A. 1). In the case at bar, no loss was sustained by the issuing corporations in selling their bonds at a discount; the loss will be sustained by the consolidated corporation when the bonds mature and are paid. Hence the deductions here in question are by way of anticipation of the taxpayer's own loss and should have been allowed."

The Circuit Court of Appeals, in the instant case, in sustaining the position of the respondent based its decision upon the theory that the deduction for un-

amortized debt discount and expense on bonds of a predecessor company may be allowed only where the predecessor company was technically merged into the company actually sustaining the loss through payment of the bonds prior to maturity. This argument was apparently based upon the prior decision of the Second Circuit Court of Appeals in *American Gas & Electric Company* v. *Commissioner,* 85 Fed. (2d) 527. We respectfully submit that the decision of the majority of the Court in the *American Gas* case was erroneous and that the correct principle was laid down in the dissenting opinion of Judge Learned Hand. In that opinion, Judge Hand states:

> "If a company keeps its books on an accrual basis and issues bonds at less than par, the discount is immediately incurred, whether one regards it as a loss or an expense. If the books are on a cash basis, the discount is not paid until the bonds are paid. Thus, in either case there is no legal warrant for spreading the deduction over the life of the bonds; the practice which has grown up and is of undoubted validity, is based upon a fiction, following the accountant's device for preparing to meet the burden of paying the discount all at once. Unless this fiction is extended to cover a buyer in 'reorganization' it will be the means of preventing the deduction of a part of what at some time or other is an undoubted loss or expense. The buyer is not a party to the original loan and cannot claim any deduction because of it; it merely buys the assets and pays for them in cash and by a promise to pay the face of the bonds. It is true that that promise includes the discount, but the cash payment presumably is less by that amount, if the bonds bear interest. Certainly the buyer has not suffered any loss, or paid any expense. Nor will

any deduction because of it appear in estimating the buyer's gain or loss, if it sells the assets in whole or in part. True, the buyer's 'basis' is the seller's 'basis,' but if the seller had sold the assets, its 'basis' would not include the discount. It would be the cost of the assets sold; that is, the amount borrowed so far as the proceeds of the bonds had been used to buy them. Therefore, all deduction for the unamortized discount disappears from the computation of the taxes of either buyer or seller, unless the buyer is allowed to complete the amortization deductions. A legal fiction is a good contrivance only if it effects a just result, but there is no excuse for it otherwise; this one must be carried out consistently in order to avoid injustice. There may be difficulties when the books are kept on a cash basis, but when as here they are not, it seems to me that the deductions of which the seller is deprived should enure to the buyer rather than be denied in toto."

We further submit that any rule which recognizes the fiction of amortization, and yet refuses to extend the fiction to its logical result, but rather restricts it in such a way as to deprive a taxpayer of a valid deduction for an actual loss, is based upon the technicalities of form, and neglects the fundamental reasoning expressed in the foregoing dissenting opinion, and also in the opinion of the Circuit Court of Appeals for the Fourth Circuit in the *Western Maryland Railway Company case, supra,* as well as in the opinion of the Circuit Court of Appeals for the Second Circuit itself, in the *New York Central Railway Company case, supra.* The true principle, we believe, should be based upon a judicial recognition of the fact that the payment of the unamortized discount is actually made,

and the loss is actually sustained, by the successor company in all cases where the transfer does not involve an arms-length sale for an independent consideration. If this principle be recognized, the proper rule of law would be that unamortized debt discount and expense, representing either additional interest or loss, should always be allowed to the corporation which actually pays it, except in cases where the circumstances show a reasonable probability that the amount of the additional interest or loss has already been compensated for in one form or another. This rule was clearly recognized by the Court of Claims in *American Gas & Electric Company* (17 F. Sup. 151), wherein it stated:

> "* * * The Securities Corporation acquired the assets of the Virginia Company by the payment of a definite consideration, and we think it is a fair presumption that the price so paid was adjusted to meet the fact that the corporation would have to pay the bonds in full."

In the instant case, this situation does not obtain. Here there was a mere change of form—an absorption of the constituent companies by the Northern Pennsylvania Power Company for a consideration designed merely to take care of the outstanding securities of the constituent companies. This consideration could not possibly have been fixed in relation to the assets transferred, and could not have taken into account the additional interest or loss represented by the unamortized discount and expense on the bonds of the constituent companies.

If in this case consideration had been paid, as in the case of an ordinary sale between corporations, the price so paid for the assets would have been diminished

so as reflect the amount of unamortized bond discount and expense, a purely fictitious asset or balance item on the seller's balance sheet. In such case the loss would have been already "compensated for" within the meaning of the Revenue Act, and, therefore, would not be deductible. Here, however, as has been pointed out, the contrary situation is evident.

Therefore, since it is impossible in the present case to infer that the price paid for the assets received by the Northern Pennsylvania Power Company was adjusted to meet the fact that the company would have to pay the bonds in full, there are no circumstances which require or permit the disallowance of a deduction for additional interest or loss actually paid or sustained by that company, and for which it received no compensation.

It cannot be said either that by claiming the deductions the Northern Pennsylvania Power Company is carrying over a loss sustained by a predecessor corporation such as in the case of *The Pennsylvania Company, etc.* v. *Commissioner,* 75 F. (2d) 719, and similar cases, or that the company is claiming a deduction for a loss which has already been compensated for by being reflected in the purchase price of the assets of the old companies as in *American Gas & Elec. Co.* v. *Commissioner,* 85 F. (2d) 527.

CONCLUSION.

It is not disputed that unamortized debt discount and expense remaining at the time that bonds are retired prior to maturity are allowable deductions for income tax purposes to a successor corporation which, through merger, has carried forward the corporate identity of the issuing corporation and has succeeded,

by operation of law, to its rights and liabilities. It is therefore contended that the deductions claimed by the petitioner's subsidiary, the Northern Pennsylvania Power Company, should be allowed since, under Pennsylvania law, the transactions here involved meet this test.

In any event the deductions claimed should be allowed since the Revenue Act specifically provides that corporations in computing their net income may deduct losses for which they have not been compensated. No loss was sustained in this case by anyone, either directly or indirectly, on account of unamortized bond discount and expense until the bonds were redeemed prior to maturity by the Northern Pennsylvania Power Company which then sustained a loss by reason of the fact that the issuing corporations had merged into it as the successor to all of their assets and liabilities. To deny the loss to the taxpayer will be to defeat the legislative intent.

It is therefore contended that the Circuit Court of Appeals for the Second Circuit erred in refusing to allow the deductions claimed by the petitioner in the consolidated income tax return filed in conjunction with its subsidiary, the Northern Pennsylvania Power Company, for the years 1926 and 1927.

Respectfully submitted,

MAURICE BOWER SAUL,
Counsel for Petitioner.

WILLIAM H. S. WELLS,
BRADFORD S. MAGILL,
C. M. TRAMMELL,
Of Counsel.

JANUARY 16, 1939.

APPENDIX A.

Purdon's Pennsylvania Statutes, Annotated (Permanent Edition), Title 15 (Act of 1909):

"SEC. 421. *Merger authorized; exceptions; exclusive franchise not extended; merger subject to act of 1907.*—It shall be lawful for any corporation, now or hereafter organized under the provisions of any general or special act of Assembly authorizing the formation of any corporation or corporations, to merge its corporate rights, franchises, powers, and privileges with and into those of any other corporation or corporations transacting the same or a similar line of business, so that by virtue of this act such corporations may consolidate, and so that all the property, rights, franchises, and privileges then by law vested in either of such corporations, so merged, shall be transferred to and vested in the corporation into which such merger shall be made: * * *

SEC. 422. *Procedure; joint agreement; approval by stockholders; certificates; approval by governor.*—Said merger or consolidation shall be made under the conditions, provisions, and restrictions, and with the powers, herein set forth; to wit,—

First.—The directors of each corporation shall enter into a joint agreement, under the corporate seal of each corporation, for the merger and consolidation of said corporations: prescribing the terms and conditions thereof, the mode of carrying the same into effect, the name of the new corporation, the number and names of the directors and other officers thereof,

and who shall be the first directors and officers, and their places of residence, the number of shares of the capital stock, the amount or par value of each share, and the manner of converting the capital stock of each of said corporations into the stock of the new corporation, and how and when directors and officers shall be chosen, with such other details as they shall deem necessary to perfect the said consideration and merger; but said agreement shall not be effective unless the same shall be approved by the stockholders of said corporations, in the manner hereinafter provided.

Second.—Said agreement shall be submitted to the stockholders of each of said corporations, at separate special meetings or at any annual meetings, of the time, place and object of which respective meetings due notice shall be given by publication, once a week for two consecutive weeks before said respective meetings, in at least one newspaper in the county or in each of the counties in which the principal office of said respective corporations shall be situate

* * *

SEC. 423. *Effect of merger; new patent; bonus; certificate of reports and payment of taxes.*—Upon the filing of said certificates and agreement, or copy of the agreement, in the office of the Secretary of the Commonwealth, and upon the issuing of new letters patent thereon by the Governor, the said merger shall be deemed to have taken place, and the said corporations to be one corporation under the

name adopted in and by said agreement possessing all the rights, privileges, and franchises theretofore vested in each of them; and all the estate and property, real and personal, and rights of action, of each of said corporations, shall be deemed and taken to be transferred to and vested in the said new corporation, without any further act or deed: Provided, That all rights of creditors and all liens upon the property of each of said corporations shall continue unimpaired, limited in lien to the property affected by such liens at the time of the creation of the same, and the respective constituent corporations may be deemed to be in existence to preserve the same; and all debts not of record, duties, and liabilities of each of said constituent corporations shall thenceforth attach to the said new corporation, and may be enforced against it to the same extent and by the same process as if said debts, duties, and liabilities had been contracted by it. * * *"

APPENDIX B.

Section 23 of the Pennsylvania General Corporation Act of 1874, as amended.

(Purdon's Penna. Statutes, Annotated (Permanent Ed.), Title 15, Section 595.)

"SEC. 595. *Reduction of capital stock; change in value of shares; conveyance of franchise and property.*—Any corporation created under the provisions of this act, and any corporation of the classes named in the second section thereof, that is now in existence by virtue of any law of this Commonwealth, may reduce its capital stock or alter and change the par value of the shares thereof, by a vote of the stockholders taken in the manner and under the regulations prescribed in the eighteenth, nineteenth, twentieth, twenty-first, and twenty-second sections of this act; and it shall be lawful for any corporation in the same manner to sell, assign, dispose of, and convey to any corporation created under or accepting the provisions of this act, its franchises, and all its property, real, personal, and mixed, and thereafter such corporation shall cease to exist, and the said property and franchises not inconsistent with this act, shall thereafter be vested in the corporation so purchasing as aforesaid: *Provided,* That the returns required by said section shall not be filed in the office of the Secretary of the Commonwealth until each and every corporation, so selling, assigning, disposing, and conveying such franchises and property, shall have filed with the Secretary of the Com-

monwealth, a certificate from the Auditor General of the Commonwealth, setting forth that all reports required by the Auditor General of the Commonwealth have been duly filed to the date of the proposed sale, assignment, disposition, and conveyance; and that all taxes due the Commonwealth of Pennsylvania have been paid up to and including such date. * * * (1874, April 29, P. L. 73, Sec. 23; 1876, April 17, P. L. 30, Sec. 5; 1915, June 2, P. L. 724, Sec. 1; 1931, June 12, P. L. 561, Sec. 1)."

APPENDIX C.

Revenue Act of 1926, c. 27, 44 Stat.:

"SEC. 200. (d) The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212 or 232. The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed under section 212 or 232, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

* * * * * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * * * * *

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

* * * * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise."